

Annual Report: Digest

Inflation and uncertainty have weakened global economic activity

- Global economic developments have been marked by persistent inflationary pressures and monetary policy tightening.
- Inflation has begun to ease thanks to the drop in energy commodity prices since summer 2022. Yet inflationary pressures remain high, after having spread to the entire consumption basket.
- Global economic activity slowed considerably over the course of 2022.
- Most recently, the global economy has shown some signs of greater dynamism.
- Euro area activity has been relatively resilient in an adverse environment, as the slowdown in 2022 H2 was less pronounced than had been expected at the end of the summer.

Spain: from the reopening momentum to resilience in the face of the energy crisis

- Spanish GDP grew by 5.5% in 2022, as a result of two very different phases: a vigorous recovery in H1 and a slowdown in H2.
- In 2022 H2 and early 2023 the Spanish economy performed better than expected.
- As a result, Spanish economic activity is 0.2% below its pre-pandemic level, while euro area GDP stands 2.5 pp above it.
- Sectorally, the pick-up in services drove growth, particularly in 2022 H1. Conversely, higher energy input prices have weighed on activity in energy-intensive manufacturing sectors.
- The relatively positive performance of the external sector, the strength of employment (underpinned by wage moderation) and the fiscal momentum have all supported activity.
- According to the economic projections for 2023-2025, the post-pandemic gap between Spanish and euro area GDP will gradually close, although uncertainty is high and persistent and there is a risk that less positive scenarios might materialise.

Slowing energy prices in Spain have helped significantly lower headline inflation in recent months, but underlying inflation remains high

- Inflation has risen sharply and persistently. Yet, after peaking in summer 2022, consumer price inflation has slowed.
- In July 2022 the year-on-year growth of consumer prices, measured by the harmonised index of consumer prices (HICP), amounted to 10.7%. It declined sharply thereafter, to 3.8% in April 2023 (according to the flash estimate).
- The rise in inflation has been mitigated by the measures deployed by the authorities since mid-2021.
- Inflation was initially driven primarily by the energy component, which started to rise in spring 2021 and was exacerbated by the consequences of the war in Ukraine.
- Both the initial rise in energy inflation and its subsequent decline have been considerably sharper in Spain than in the euro area.
- The rise in inflation has been passed through to food consumer prices and non-energy industrial goods and services prices (i.e. the underlying component of the HICP).
- The slowdown in energy prices since summer 2022 is behind the decline in headline inflation since then.
- Unlike energy inflation, underlying and food inflation remain very high. In light of the signs of price growth moderation in the initial stages of production processes, the incipient deceleration should bear out in the near future.
- From a cost perspective, unit profits have of late contributed more to value added deflator growth than unit labour costs.
- Despite the steep rise in consumer prices, wage settlements are proving moderate, which has resulted in a significant fall in real wages.
- Profit margin containment and labour cost moderation will be key to avoiding significant second-round effects on inflation.
- Non-energy inflation is expected to gradually decelerate over the period 2023-2025.

Inflation and tighter financing conditions weakened consumption and investment in 2022 H2

- The rise in inflation – and the attendant erosion of household purchasing power – and tighter financing conditions have adversely affected private investment and consumption.
- The higher cost of new debt has started to impact loan demand and the debt service burden has increased for agents with floating-rate debt.
- Almost half of the extraordinary savings built up by households during the pandemic are held in bank deposits, but these funds are unlikely to give a significant impetus to consumption.
- Residential investment has also proven considerably weak recently. This is due to the gradual loss of household purchasing power, the fact that bank lending has progressively become more expensive and difficult to access and the high uncertainty.
- Private productive investment has also lost considerable momentum since spring 2022 amid growing production costs, high uncertainty and tightening financing conditions.
- Government spending under the Next Generation EU (NGEU) programme increased modestly in 2022 and, therefore, its impact on the spending of final agents remains limited.

The external sector was key to sustaining output growth

- The Spanish economy's external sector has performed fairly well recently.
- Net exports made a sizeable contribution (2.4 pp) to GDP growth.
- As far as real trade flows are concerned, services exports were notably buoyant, particularly in terms of international tourism.
- Conversely, trade in goods has seen much more muted growth recently, above all in terms of exports.
- Despite rising energy costs, the Spanish economy has proven more competitive in recent times.
- Even though energy prices have risen sharply, the contraction in the current account surplus was relatively small in 2022.
- Compared with the pre-pandemic period, the deterioration in Spain's goods and services balance has been much more modest than in other major euro area countries.

Domestic and supranational European economic policy responses in recent quarters

- The European authorities have responded resolutely to the Russian invasion of Ukraine and the challenges it has posed by implementing a wide range of measures in multiple areas.
- In the energy domain, the launch of the European Commission's REPowerEU programme stands out. This plan combines a series of initiatives aimed at diversifying the EU's fossil fuel supply sources, stepping up energy saving and speeding up the deployment of renewables.
- In late 2021 the ECB embarked on a process of tightening in response to the high and persistent inflationary pressures.
- The national authorities of the EU Member States have also adopted manifold initiatives in response to the surge in prices.
- It is estimated that the measures adopted in Spain since mid-2021 to mitigate the consequences of high inflation for economic agents will have a budgetary impact of around €37 billion between 2021 and 2025.
- An initial taxonomy of the measures breaks them down into those aimed at easing the increases in the price of some of the goods whose price has risen the most and those that seek to prop up the income of certain groups of agents.
- Overall, the measures rolled out in Spain (and in the euro area) do not sufficiently target the hardest hit agents. Measures better designed to target the most vulnerable agents would have been more effective, at a lower fiscal cost, in mitigating the impact of the inflationary crisis on such agents.
- Overall, the measures rolled out have helped reduce inflation and boost activity.

The lack of convergence with per capita income in the euro area

- The Spanish economic growth observed in recent decades has not been sufficient to achieve convergence with the per capita income level in the euro area. This lack of convergence is fundamentally determined by the persistence of two well-known shortcomings: low productivity and a low employment rate, which have also traditionally correlated negatively.
- Specifically, the gap with the euro area shrank to its narrowest in 2005. This was the result of very strong growth in employment, but it was accompanied by worsening productivity and the build-up of significant macroeconomic and financial imbalances, which translated into a deep recession in Spain in the wake of the global financial crisis.
- Remedying these shortcomings while avoiding the build-up of other significant macroeconomic, financial or social imbalances should be one of the central aims of Spanish economic policy.

The role of innovation in productivity

- Any factor that artificially constrains business growth or the ability to reallocate factors of production across firms and sectors ultimately results in less buoyant innovation and productivity in the economy. Examples here include aspects relating to the volume and quality of regulation, barriers that affect firms' creation, growth and winding up, and shortcomings in the cross-firm allocation of capital.
- Various legislative initiatives have been undertaken in recent quarters in an attempt to bolster business growth and entrepreneurship and facilitate the efficient reallocation of factors, and will need to be assessed in the future. It would also be worthwhile undertaking a review of the regulatory thresholds which discourage business growth, reducing the delay on general government payments (which hampers financing for small firms), ensuring market unity, bolstering competition and continuing to broaden sources of funding available to firms (which will require headway to be made in the capital markets union).
- Properly designed public investment can lead to positive spillovers to private investment (both overall and on R&D&I). However, in Spain, it has been persistently below the average observed for the euro area, particularly since the global financial crisis. The Next Generation EU (NGEU) programme, both in its scope and its structural approach, represents a unique opportunity to remedy this situation. There is also room to evaluate and overhaul the design of tax incentives and direct subsidies for R&D&I projects.
- The design and implementation of the NGEU programme represents a significant challenge for the Spanish general government, but it also presents a great opportunity to modernise and digitalise.

The employment rate and labour supply: key features

- A persistently low level of employment is another crucial factor in understanding the Spanish economy's lack of convergence with the per capita income level of the euro area. Spain's relatively low rate of employment is a reflection of the higher impact of unemployment.
- The Spanish labour market's structure has given rise to significantly higher unemployment levels and more widespread use of temporary job contracts than the euro area average.
- More recently, several regulatory changes have altered the Spanish labour market. Among other measures, the 2021 labour market reform cut down on temporary contracts in exchange for making some permanent hiring modalities more flexible, and expanded the role of furlough schemes (ERTEs, by their Spanish acronym) as an employment adjustment mechanism. Any thorough assessment of this labour market reform will require analysis of its impact on a range of areas.
- The high levels of unemployment seen in Spain in recent decades have a strong structural component. In this respect, it is essential to examine the role of active and passive employment policies. Squaring protection for the more vulnerable groups with appropriate incentives on the labour supply-side calls for greater coordination between the two policies.
- Human capital endowment is a key determinant of productivity, capacity to innovate and employment. The educational attainment level of employers, the self-employed and employees in Spain is lower than the euro area average. This undermines equality of opportunity, as the differences in educational attainment level are relatively persistent.

The employment rate and labour supply: key features
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- Education policies should be geared towards increasing human capital and fostering versatility. It is crucial to assess the lifetime employment return associated with different percentages of practical and academic studies in vocational training, as there is evidence that practical studies are useful for fostering an immediate transition to the labour market, but not necessarily for developing a professional career, where academic studies would have the advantage. Aside from the changes introduced by the Law on the university system, it would be useful to make progress in linking the system's funding to excellence targets and to develop initiatives to increase the proportion of graduates in STEM subjects (Science, Technology, Engineering and Mathematics). A detailed efficiency analysis should also be carried out of public spending on education.
- Looking ahead, population ageing and hours worked per employee could play a key role in the course of labour supply and per capita income in Spain and thus in the country's convergence with the euro area.
- Population ageing would be even more pronounced were it not for the positive and relatively high net migration expected in Spain in the years ahead. The capacity of new migration policies to effectively smooth any mismatches arising in the labour market should be continuously monitored.
- An additional aspect that may have a bearing on labour supply is the Spanish population's health and its evolution over time. Given its importance, priority should be given to assessing the efficiency of public spending on health.

Main imbalances in the Spanish economy

- The Spanish economy has shown a more balanced growth pattern since the outbreak of the global financial crisis, and has corrected some of the macro-financial imbalances that built up in the prior expansionary phase. The intense deleveraging carried out by households and firms is noteworthy. Also worthy of mention is the notable correction of the external imbalances in recent years.
- Nevertheless, the sustainability of the Spanish economy's growth path faces enormous structural challenges.

Public indebtedness

- Despite declining as a percentage of GDP, the general government deficit and debt remained at very high levels in 2022, both on a historical and an international comparison. The estimates available show that Spain's budget deficit has a high structural component. In this respect, it should be noted that the deterioration in the structural deficit between 2019 and 2022 was largely determined by the increase in structural primary expenditure.
- The far-reaching demographic changes under way in Spain will, in the coming decades, lead to a significant increase not only in spending on pensions, but also on health and long-term care.
- While subject to much uncertainty, an overall analysis of the main legislative changes to the Spanish pension system since 2021 suggests that it will foreseeably be necessary to adopt new measures from 2025 to shore up the system's financial sustainability. A further source of uncertainty is the potential impact of the revenue-raising measures adopted in 2023 on employment, wages and the competitiveness of the Spanish economy. The above considerations, especially bearing in mind the significance of the changes implemented, make an ongoing, transparent and thorough assessment of the magnitude of their effects advisable, including their impact on intergenerational equity.
- The sustainability of Spain's public finances would be significantly bolstered in the coming years if a fiscal consolidation plan and an ambitious package of structural reforms are implemented. Various considerations on public expenditure and revenue could serve as a guide for designing such a consolidation strategy.
- In the short term, the roll-out of the NGEU European funds could soften the impact of the economic slowdown that might be triggered by the start of the fiscal consolidation process. Embarking on a gradual process of bolstering public finances could be compatible with maintaining some of the tax support measures in place for the more vulnerable groups.
- There is broad consensus on the need to reform the European Union's fiscal governance framework, a key element of the European institutional architecture. On 26 April 2023, the European Commission published a legislative proposal for the reform of this fiscal governance framework.
- In any event, beyond this review of the fiscal rules (which should result in the adoption of a new framework in the coming months), there is considerable scope for improvement to continue strengthening Europe's institutional infrastructure and economic governance.

Household vulnerabilities

- Focusing on the differential impact of economic developments on different population groups is crucial.
- In recent years, the Banco de España has very actively contributed to identifying these differential impacts in the Spanish economy. The studies carried out have documented, inter alia, certain pockets of social, economic and financial vulnerability in Spanish households, which appear to be especially concentrated on those with lower incomes.
- The root cause of these vulnerabilities varies significantly, and mitigating their effects requires that government measures be put in place in very different areas and calls for an ongoing and thorough assessment of the capacity of these measures to attain the proposed goals and their implications in terms of equity and efficiency.
- Housing affordability, which has tightened in recent years, for both home ownership and rentals, is one domain in which particular vulnerability is observed. Among lower-income groups, the higher demand for rental housing is associated with the labour market situation and mortgage lending standards. The insufficient growth of supply to absorb the strong increase in demand appears to lie behind the considerable momentum of rental prices since 2014.
- The future Law on the right to housing places greater emphasis on the need to increase the supply of rental housing. However, some of the measures included, such as rent control, could have unwanted effects in the medium term. According to the economic literature, while price controls can reduce rents in regulated areas in the short term, they can also bear adversely on rental supply and create real estate market segmentation. Tax and regulatory measures could also be considered with a view to increasing the supply of rental housing from the professional private sector.

Euro area inflation has started to moderate, but the broad-based spread of inflationary pressures remains unfinished

- Inflation began to decline in autumn 2022 in the euro area and somewhat earlier in Spain, in both cases driven by the drop in the energy component.
- In the short term, the downward correction of inflation is expected to continue. This moderation is explained by mechanical factors such as the negative base effects, falling commodity prices, the recent appreciation of the euro and the extension of the fiscal measures to protect households and firms from inflation.
- Over the medium term inflation is expected to continue to decline towards levels compatible with the monetary policy target at that horizon.
- The easing of global supply chain bottlenecks, the reversal of indirect effects due to lower energy prices and the economic slowdown already observed in the second half of 2022 will help curb underlying inflation.
- Although upside risks to inflation have moderated, some risk factors – such as the course of the war in Ukraine, the impact on global inflation of China's economic reopening after abandoning its zero-COVID policy, possible asymmetries in the consumer price response or potential second-round effects via wages and profit margins – generate uncertainty about the reach of the disinflation process.
- Inflation expectations in the euro area, which currently remain anchored at around 2%, will be crucial for price and wage-setting.

In response to the growing inflationary pressures, the European Central Bank (ECB) began a process of monetary policy tightening

- From end-2021 the ECB shifted to a tighter monetary stance in order to meet its primary objective of keeping inflation at 2% over the medium term.
- In a first stage, net asset purchases were discontinued. Next, policy rates began to be raised, with a cumulative increase between July 2022 and the cut-off date for this report of 375 bp.
- To strengthen the pass-through of the policy rate increases to bank lending conditions, in October 2022 the ECB Governing Council also decided to recalibrate the criteria for the third series of TLTROs. The reduction in asset holdings purchased under the APP started in March 2023 and will continue at a measured and predictable pace, with reinvestments expected to be discontinued as of July.
- Future decisions will ensure that policy interest rates will be set at sufficiently restrictive levels to return inflation to the 2% target over the medium term and will be kept at those levels for as long as necessary. In addition, they will continue to be based on the ECB's assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

The chapter analyses the transmission of monetary policy to financial conditions

- The impact that the measures adopted by the ECB have had and will have in the future is felt in different stages and through different channels. In a first stage, the tightening of monetary policy impacts financial conditions through different channels: the capital markets channel, the bank channel, the income channel, the wealth channel and the exchange rate channel. In a second stage, the tightening of financial conditions lowers aggregate demand and reduces inflation.
- Capital markets channel: the euro area risk-free interest rate curve has shifted upwards since end-2021. The increase in such interest rates has fed through immediately to the capital market financing costs of firms and general government.
- Bank channel: credit institutions have gradually passed the increases in market rates through to their new loans and deposits. In the euro area overall, the pass-through to the cost of new household mortgage lending is occurring at a pace similar to that of past cycles, but somewhat more quickly in the case of lending to firms.
- Conversely, in terms of remuneration on new time deposits, the pass-through to households has been slower, while that to firms has been similar or somewhat slower, depending on the term. Broadly speaking, in Spain the pass-through has, to date, been more sluggish than might be expected based on the historical regularities.
- Income channel: higher interest rates have begun to have an impact on the income of households and firms. These effects have been more pronounced in Spain, particularly for households – essentially reflecting the strong prevalence of floating rate contracts in the stock of mortgages – and to a lesser extent for firms.
- In the case of general government, as compared with previous cycles, the higher level of indebtedness has amplified the pass-through to the debt burden. However, this effect has been dampened by the lengthening of the average life of outstanding debt.

The chapter analyses the transmission of monetary policy to financial conditions (cont'd)

- Wealth channel: the value of household wealth has been negatively affected by monetary policy tightening, via its adverse impact on asset prices, although other factors have also had an influence.
- Exchange rate channel: the euro exchange rate has tended to depreciate against other currencies, although there has been reverse movement in the most recent period. This depreciation mainly reflects an earlier and stronger monetary policy tightening in other regions compared with the euro area.

The transmission of monetary policy is highly uneven across countries and sectors

- There is significant cross-country heterogeneity in monetary policy transmission. In the bank channel, the different speeds of monetary policy transmission to households' mortgage and time deposit rates seem to reflect both banks' idiosyncrasies and differences in each country's banking sector structure.
- There is also considerable heterogeneity in the income channel across Spanish households and firms, which amplifies the effect of interest rate rises on aggregate consumption and investment.

The chapter also estimates the effects of the monetary policy measures on economic activity and inflation

- The monetary policy tightening is already beginning to pass through to real activity and inflation, but the bulk of the impact will be felt from this year onwards.